

CHAPTER 4

CHINA'S REGIONAL ECONOMIC AND SECURITY IMPACTS AND THE CHALLENGES OF HONG KONG AND TAIWAN

“REGIONAL ECONOMIC AND SECURITY IMPACTS.

The Commission shall assess the extent of China's “hollowing out” of Asian manufacturing economies, and the impact on United States economic and security interests in the region; [and] review the triangular economic and security relationship among the United States, Taipei and Beijing. . . .” [P.L. 108–7, Division P, Sec. 2(c)(2)(F)]

KEY FINDINGS

- China is gaining influence in Asia through its rapidly increasing economic weight and successful diplomacy. China is strengthening bilateral economic and security ties with nearly all countries on its periphery and energizing regional trade and security groupings, such as the Shanghai Cooperation Organization (China, Russia, and four Central Asian states) and the multilateral fora of the Association of Southeast Asian Nations (ASEAN). As never before in modern times, countries throughout Asia are weighing the China factor in their external relations and economic strategies.
- During 2002–03, China became the single largest export market for Japan, South Korea, and Taiwan, eclipsing the United States. In Northeast and Southeast Asia, exports have been driven by China's surging demand for commodities, equipment, and industrial inputs. At the same time, employment, investment, and production in some industries in the region have been adversely affected by a shift of foreign direct investment (FDI) to China and the emergence of China as a major manufacturing power in product lines once dominated by other Asian manufacturers.
- China is extending its influence even as the United States is widely perceived in the region as preoccupied with Iraq, North Korea, and the global war on terrorism and paying less attention to the region's economic, trade, and development issues. The United States is seen as having allowed the regional trade liberalization mechanism of the Asia Pacific Economic Cooperation (APEC) process to atrophy in favor of pursuing bilateral free trade agreement (FTA) negotiations.
- China's leaders have rebuffed Hong Kong society's growing demand for direct elections and more responsive government. A recent decision of the National People's Congress Standing Committee (NPCSC) rules out until at least 2012 direct election of Hong Kong's chief executive or the full Legislative Council. This has dashed hopes for early achievement of universal suffrage in

Hong Kong and has seriously set back Hong Kong's ability, under the "one country, two systems" formula, to decide how to govern itself. The significant erosion of Hong Kong's autonomy is a matter to be considered under the terms of the U.S.-Hong Kong Policy Act.

- China has employed its economic and political leverage to isolate Taiwan further by excluding it from most regional economic fora and discouraging others from negotiating bilateral trade agreements with Taiwan, which is entering a critical period in its modern history. Under the terms of the Taiwan Relations Act (TRA), this development should be of concern to the United States.
- Taiwan faces the challenge of solidifying its own political identity and buttressing its security while still finding a way to support its trade and investment interests by gaining direct transport and communications links with the PRC. Business interests in both Taiwan and the United States see direct cross-Strait links as crucial to preventing Taiwan's further marginalization in a regional economy that is increasingly centered on China. There has been no formal cross-Strait dialogue on these matters since 1998.
- Cross-Strait tensions have increased in the past year. Factors include China's continuing military buildup and missile deployments opposite Taiwan, the holding of referenda in Taiwan on the questions of missile defense and cross-Strait relations, the reelection of Taiwan President Chen Shui-bian, and President Chen's proposal for constitutional revision in 2008—to be set in motion by a possible referendum in 2006—that the PRC has equated with an unacceptable timetable for independence.

OVERVIEW

In the past two years, China has become even more central to regional and global trade, investment, and production patterns than it was at the time of the Commission's first Report to Congress. The trends the Commission identified in 2002 accelerated as a result of China's December 2001 accession to the WTO and the attendant granting of Permanent Normal Trade Relations status to China.

In the past two years, China has linked its growing economic power with strong diplomatic initiatives throughout Asia. China's softer approach to the region has been dubbed a smile campaign or charm offensive, but it is more than just that—China has injected new energy into bilateral partnerships and multilateral trade and security arrangements.¹ China's active participation in regional groupings such as the Asia Pacific Economic Forum, the Shanghai Cooperation Organization (SCO), and One ASEAN Regional Forum reflects China's use of multilateralism as a tool for pursuing its economic and political interests.²

This regional diplomatic effort is designed to serve China's stated strategy of peace and development by promoting a stable security environment and its own access to the world trading system, while it concentrates on domestic economic development and strengthening its military.³ It also raises considerable challenges for the United States' economic and security relations with the countries of Asia. Some observers consider the implications for longer-term

U.S. interests to be alarming. As one witness who testified before the Commission wrote: "China is patiently and systematically amassing a geopolitical presence of superpower proportions in Asia. Washington must start to take China seriously as a potential great power competitor in the region."⁴

China-Taiwan relations are entering another period of transformation as two contradictory trends play out. On the one hand, Taiwan investors, particularly those in the information technology (IT) sector, have been pouring money, managers, plant, and equipment into ventures on the mainland. Cross-Strait trade and investment flows are at an all-time high, with the direction of both investment and exports going largely from Taiwan to the mainland. Although mainland exports to Taiwan have increased, Taiwan tightly restricts inward investment from the PRC for security purposes. On the other hand, political attitudes on both sides of the Strait have hardened. There is effectively no public dialogue across the Taiwan Strait. China continues to work to isolate Taiwan internationally. As the rest of Asia and the world establish direct links with Chinese ports, airports, investment zones, and financial centers, Taiwan's potential as a platform for servicing trade and investments in China has dwindled. Taiwan is becoming marginalized further in the regional economy.

The Commission seeks to assess the degree of regional influence China has gained through its growing economic power and the implications for U.S. economic and security interests in the region. This assessment includes the questions of how economic integration and central-local political dynamics are affecting Hong Kong's health as a major international finance, services, and transport center; and how cross-Strait economic relations are influencing Taiwan's economy and security.

On December 4, 2003, the Commission held a hearing on *China's Growth as a Regional Economic Power: Impacts and Implications*. Witnesses from academia and research institutions testified on China's growing influence in Asia through its burgeoning diplomatic and commercial ties with neighboring countries and intra-Asian regional groups such as ASEAN.

During the September 25, 2003, hearing on *China's Exchange Rate, Investment, and Industrial Policies* and the February 12–13, 2004, field hearing in San Diego on *China as an Emerging Regional and Technology Power: Implications for U.S. Economic and Security Interests*, various panels discussed China's impact on regional economic trends, especially through its growing importance as a manufacturing hub within global supply networks.

From March 14 to 23, 2004, a delegation of Commission members and staff traveled to Tokyo, Hong Kong, and Taipei for discussions with officials, American and local business representatives, academics, and media representatives on regional economic, political, and security questions.

ANALYSIS AND FINDINGS

Regional Trade and Investment

Regional trade and investment patterns that emerged in the second half of the 1990s have become more pronounced in the past

two years. A high volume of inward FDI—the majority of it originating in East Asian economies—continues to fuel China’s export-driven economic boom even as global levels of FDI have dropped.⁵ China’s December 2001 entry into the WTO locked open China’s access to its key export market, the United States. This sharply reduced the perceived risk premium for FDI in China and intensified FDI inflow. This has implications for all regional economies but especially for the countries of Southeast Asia, which have already experienced a relative decline in FDI flows and could lag behind China in technological progress.⁶

China received the largest amount of inward FDI of any nation in 2002—\$52.7 billion—after averaging about \$40 billion per year for the previous seven years. As pointed out in the Commission’s 2002 Report, FDI projects in China are concentrated on new, green-field investments, whereas FDI directed into the United States generally takes the form of foreign purchases of existing American firms.⁷ Global flows of FDI to China over the past seven years exceeded those to the rest of East Asia (excluding Hong Kong) combined, including Japan and Singapore. The large stock of FDI in China—estimated to be nearly \$550 billion at the end of 2003⁸—is a reflection of China’s becoming thoroughly enmeshed in global production networks.⁹ As indicated in figures 4.1 and 4.2, the United States has contributed a relatively small share—on average about four percent—of China’s annual flows and cumulative stock of FDI, the bulk of which is sourced from within Asia, notably Taiwan, Hong Kong, Japan, South Korea, Thailand, and Singapore.

Figure 4.1 World FDI Inflows Into Asia, 1997–2002 (Billions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	1997–2002
China	\$44.2	\$43.8	\$40.3	\$40.8	\$46.8	\$52.7	\$268.6
Hong Kong	11.4	14.8	24.6	61.9	23.8	13.7	150.2
China & Hong Kong	55.6	58.5	64.9	102.7	70.6	66.4	418.8
Japan	3.2	3.2	12.7	8.3	6.2	9.3	43.1
Indonesia	4.7	–0.4	0.0	0.0	0.0	–1.5	2.8
Korea, Rep. of	2.8	5.4	9.3	9.3	3.5	2.0	32.4
Malaysia	6.3	2.7	3.9	3.8	0.6	3.2	20.5
Philippines	1.2	1.8	0.6	1.3	1.0	1.0	7.0
Singapore	10.7	6.4	11.8	12.6	10.9	7.7	60.2
Taiwan	2.2	0.2	2.9	4.9	4.1	1.4	15.9
Thailand	3.6	5.1	3.6	3.4	3.8	1.1	20.5
Vietnam	2.6	1.7	1.5	1.3	1.3	1.2	9.6

Source: UN Conference on Trade and Development, www.unctad.org; time series figures revised 2003.

Figure 4.2 U.S. FDI Inflows Into Asia, 1997–2002 (Billions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	1997–2002
Asia/Pacific	\$13.7	\$14.7	\$21.0	\$21.0	\$14.7	\$28.8	\$113.9
Australia	1.2	6.3	4.9	0.9	−0.4	3.7	16.6
China	1.3	1.5	2.6	3.1	1.2	0.9	10.6
Hong Kong	3.8	1.9	4.2	4.3	4.4	2.0	20.6
China + HK	5.1	3.4	4.2	4.3	5.6	2.9	25.5
Indonesia	—	0.5	2.2	1.2	0.026	0.4	4.3
Japan	−0.3	6.4	5.2	8.1	2.3	4.5	26.2
Korea, Rep. of	0.7	0.6	1.2	1.2	1.3	1.4	6.5
Malaysia	0.7	−0.5	—	0.3	−0.004	9.4	9.9
Philippines	0.1	0.3	−0.3	—	−0.4	0.7	0.4
Singapore	3.7	0.3	3.0	2.7	3.8	11.4	24.9
Taiwan	0.7	−0.6	0.6	1.1	0.9	0.9	3.6
Thailand	—	0.4	1.1	0.5	0.8	0.9	3.7

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

China's entry into the WTO, increasing inflows of FDI, and the new production capacity built up in China have led to an unprecedented expansion of China's trade volume. China's total goods trade increased by twenty-one percent in 2002 and by thirty-seven percent in 2003 (with a forty percent rise in imports). Without taking into account transshipments of imports and exports through Hong Kong, China is now the fourth largest trading and exporting nation in the world, after the United States, Germany, and Japan; if Hong Kong's transshipment trade is included, China's total would exceed Japan's. By any measure, China became the third largest importing country in the world in 2003, behind only the United States and Germany.¹⁰

By the end of 2003, China became the single largest export market for Japan, South Korea, and Taiwan, eclipsing the United States. All three economies enjoyed significant trade surpluses with China in 2003 (Taiwan, \$40 billion; Korea, \$23 billion; Japan, \$15 billion).¹¹ China's total trade turnover with the ASEAN countries rose to \$78 billion in 2003, with China's imports from ASEAN nations up fifty percent, to \$47 billion (versus \$31 billion in China's exports to ASEAN), giving the ASEAN grouping a surplus of \$16 billion.¹² These regional merchandise trade surpluses reflect China's centrality to global supply chains producing manufactured goods for developed country markets; they are the flip side of China's \$124 billion trade surplus with the United States in 2003.

The economic center of gravity in Asia is shifting from Japan to China. Japanese policymakers are increasingly concerned about the long-term strategic consequences of China's rise. The ongoing shift

of production and FDI to China upset long-standing regional manufacturing networks centered on Japan. In the past several years, large Japanese international firms have recognized that establishing a production base in China is essential to their future financial health. In the 1980s and 1990s, Japanese firms dominated production chains set up in Southeast Asia that channeled exports of industrial inputs from Japan and finished manufactures from Southeast Asia to Japan and other world markets. During this period, Japanese companies outsourced a relatively small percentage of their production overseas, and spent a fairly low level of investment in China compared with other regions.¹³

After the Asian financial crisis (1997–98), the productivity of investment in Southeast Asia declined relative to China, and Japan found its product lines challenged by new production coming out of China. In the late 1990s and early 2000s, Japan increased its investments in China and sourced more of its production in China. In the late 1990s, Japanese companies and localities began to express serious concerns about the hollowing out of manufacturing sectors that had moved to China, but in the past few years the shift of production to China has only accelerated. The profitability of Japanese investments in China reportedly has also increased markedly in the past two years.¹⁴

South Korea's flow of investments into China amounts to less than five percent of total domestic investment and some Koreans see their companies' association with China as benefiting their own domestic economic reforms. Increased South Korean exports to China have helped bolster already buoyant relations between the Republic of Korea (ROK) and the PRC, whose economic interests seem more aligned than ever.¹⁵ Some analysts believe the ROK economy has suffered dislocations from trade and investment ties with China, however. Korean heavy machinery manufacturers, for example, are reportedly transferring operations to the PRC. South Korea feels these economic shifts to China perhaps more than a larger Japan does. For example, Shanghai and Shenzhen ports have grown at double digits and surpassed Pusan to become the third and fourth busiest container ports in the world. South Korea's global textile exports dropped to a thirteen-year low in 2003 of \$15.2 billion, largely as a result of increased competition from China. Meanwhile, a new trend suggests a possible Chinese strategy to gain greater economic advantage in the future: Chinese firms seeking Korean technology and experience are beginning to invest in Korea in strategic industrial sectors.¹⁶

Rapid growth in exports from the rest of Asia to feed China's manufacturing sector has taken some of the sting out of hollowing out. In 2003, most major Asian economies ran substantial trade surpluses with China. The question is whether China will continue to move up the technology ladder to such an extent that its current imports from the rest of Asia will slow or change in composition. Classical development economists contend that Japan, South Korea, Taiwan, and the ASEAN nations have no choice but to rise to China's challenge by advancing their own technological base if they want to remain competitive, maintain domestic employment, and improve standards of living.¹⁷

Chinese production and export of textiles and garments are expected to surge and remain at high levels following the complete phasing out of quotas under the WTO Multifiber Arrangement, as of January 1, 2005, and put added competitive pressure on marginal producers in South and Southeast Asia. According to a set of econometric models presented to the Commission, a combination of FDI diversion and increased Chinese textile and garment production due to the end of MFA quotas could lead to a net loss of national income in the countries of Southeast and South Asia if China's attraction of FDI is accompanied by technological advancement.¹⁸

China's Regional Diplomatic Offensive

China's regional diplomacy serves its global economic strategy, which is to maintain access to the open, multilateral trading system upon which its rapid growth depends. It also complements China's national security strategy by conditioning regional actors to its peaceful rise, a trend increasingly seen as economically positive and politically benign among many regional actors, notably South Korea and the ASEAN nations.

Asia is going through historic geopolitical changes due to the rise of China. The region is in search of a new order to accommodate China's growing power and influence and to maintain regional peace and stability.¹⁹ China's strategy of promoting bilateral and regional dialogues, trade agreements, and confidence-building measures is consistent with its stated foreign policy goal of peace and development. Chinese media have lately begun to characterize China's emergence as a regional economic and political power as a peaceful rising (*heping jueqi*).²⁰

The 2001 APEC summit meeting in Shanghai is a convenient demarcation line for a new assertiveness in China regional policies. Since then, China has shown (1) a more proactive stance in pursuing strategic partnership agreements and adding substance to them; (2) increased support for and participation in regional security mechanisms, notably the Shanghai Cooperation Organization, the ASEAN Regional Forum, and bilateral military exercises; and (3) an emphasis on its economic and political influence, while downplaying its growing military strength.²¹

China touts its policy of noninterference in the internal affairs of other states and contrasts its hands-off approach to that of the United States, which actively pursues an agenda to combat terrorism and to promote human rights and democratic governance. Aside from reiterating the importance of partners accepting its "one China" principle vis-à-vis Taiwan, China makes few political demands on its Asian neighbors. Needless to say, China does not push human rights, labor, or environmental standards in its diplomacy.

China's regional strategies are driven in part by its energy security needs, as discussed in Chapter 6. Major pipeline projects are being planned to connect China to oil and gas fields in Central Asia and the Russian Far East. Moreover, Chinese energy firms have signed long-term contracts to import liquefied natural gas from Australia, Indonesia, and Iran.

China has continued to promote the establishment or strengthening of regional multilateral institutions, such as the Bangkok Agreement, the Shanghai Cooperation Organization (China, Russia, and four Central Asian nations), and the ASEAN Plus One (China) and Plus Three (China, Japan, South Korea) fora.

China is extending its influence even as the United States is widely perceived in the region as preoccupied with Iraq, North Korea, and the global war on terrorism to the exclusion of regional economic, trade, and development issues. While pursuing a global agenda of bilateral free trade agreement negotiations, the United States is seen as having allowed the regional trade liberalization mechanism of the APEC process to atrophy.²² On the other hand, the U.S. government has not directly challenged China's diplomatic gains in the region, seeming in general to welcome what could be considered healthy economic cooperation and confidence-building measures, such as China's recent search-and-rescue and naval exercises with the Pakistani, Indian, and French navies, respectively.

Chinese Initiatives in Southeast Asia

At the eighth ASEAN summit meeting in Phnom Penh, Cambodia, in November 2002, China's Premier Zhu Rongji announced several diplomatic initiatives. On behalf of the PRC government, he

- forgave the debts of Vietnam, Laos, Myanmar, and Cambodia;
- announced duty-free treatment of imports from Cambodia, Laos, and Myanmar and promised to extend most-favored-nation (MFN) treatment of imports from Vietnam;
- signed on to a Declaration on the Conduct of Parties in the South China Sea; and
- agreed to a framework agreement on the ASEAN-China Free Trade Area—an arrangement that China's Vice Premier Wen Jiabao had proposed in November 2001.²³

On October 8, 2003, at the ninth ASEAN summit in Bali, Indonesia, China acceded to the 1976 Treaty of Amity and Cooperation—the founding nonaggression pact of the ASEAN grouping. China, soon followed by India, was the first non-ASEAN country to join the pact. The ASEAN governments and China also signed in Bali a Joint Declaration on Strategic Partnership for Peace and Prosperity, which lays out a program to strengthen cooperation on political, security, economic, social, and regional issues. They committed to an enhanced regional security dialogue as well as to the goal of expanding China-ASEAN trade to \$100 billion by 2005.

China's proactive diplomacy with the ASEAN countries appears to be working. According to Sarasin Viraphol, a former Thai diplomat, "More and more, China is doing the things the United States used to do: cooperating, pushing trade, offering help. . . . People are less scared of China now."²⁴ Kavi Chongkittavorn, a senior editor of the Nation newspaper group in Thailand, says the ASEAN region has been seized by "a China fever, an excitement, [where] all anybody wants to talk about are the opportunities." A recent survey by the Bangkok-based Kasikorn Research Center showed that more than seventy-five percent of Thai respondents see China as Thailand's closest friend, compared to nine percent for the United States and fewer than eight percent for Japan.²⁵ Professor

Wang Gungwu, director of the East Asian Institute, National University of Singapore, testified to the Commission that China's proactive stance "has been a tremendous boost to ASEAN." He said China's involvement has led to Japan and South Korea showing new interest and has also affected how India and Australia see ASEAN; he expressed the hope that perhaps the United States would also pay more attention to ASEAN.²⁶

Japanese Economic and Security Concerns²⁷

The official Japanese position on China's rise remains what Prime Minister Koizumi said to visiting PRC National People's Congress Standing Committee Chairman Wu Bangguo on September 5, 2003: "China's growth is not a threat to, but an opportunity for, Japan." Of all the United States' friends and allies in the region, Japan nevertheless appears the most prepared to consider seriously how to respond to China's growing power and influence, both in coordination with the United States and on its own. For Japan, China is the number one issue for the economy and for Japan's future security, although this is often left unspoken.

Given China's high level of FDI, cutthroat internal competition among manufacturers, and low cost of production, Japanese companies have minimal pricing leverage over the manufactured goods they produce in the China market either for internal consumption or for export. Japanese companies exporting industrial inputs and capital equipment into the hot China market find themselves doing well, although Japanese industries face rising raw materials costs (for steel, chemicals, and fiber) largely because of huge and growing Chinese demand. Corporate profits in Japan thus may not benefit from the China factor as much as some had hoped.

As China moves up the technology ladder—in semiconductor manufacturing, biotechnology, telecommunications, and electronic equipment—the question arises of how Japan can fuel China's advance and still retain its own technological superiority over time. This is causing much reflection in Japan—as in the United States—about the need for a strategic reassessment of the needs of the country's innovation infrastructure, including venture capital sources, education and technical training, and research and development.

Japan shares with the United States some more immediate concerns about its companies' ability to compete with China's domestic producers—both in China's domestic market and in third markets—if certain PRC government policies are allowed to stand. The Japanese government, like the United States, is considering how to respond to China's attempts to set a new range of technical standards for new information technologies, such as software standards for advanced cell phones and DVD players and new encryption standards for wireless LANs. Like the United States, Japan sees China's discriminatory tax on imported semiconductor chips as violating WTO norms and has filed a WTO dispute settlement case in parallel with that of the United States.

In the security realm, there is a growing willingness among Japanese officials to discuss what Japan must do to prepare for the security challenges of an economically and militarily powerful China. Japanese national security officials have expressed the view that

Japan's national security would be directly affected by any conflict scenario involving Taiwan by virtue of Taiwan's proximity to Japanese islands and territorial seas. Chinese aggression toward Taiwan would thus not only affect Japan's security interests through the U.S.-Japan alliance, but also directly.

In shaping its defense forces, Japan considers a broad spectrum of possible conflict scenarios. While North Korea poses the most prominent and near-term threat, Japan is also taking note of China's acquisition and development of more sophisticated air and naval weapons systems as well as its ballistic missile force. Japan is procuring or indigenously producing systems that will be useful in countering a longer-term Chinese threat, such as AWACS, air-refueling tankers, AEGIS-equipped destroyers, maritime patrol aircraft, and the SM-3 surface-to-air missile. Japan faces challenges in maintaining a strong defense-industrial manufacturing and R&D base. Its national restrictions against exporting arms constrain its ability to reduce production costs and support R&D efforts across a range of capabilities. Even if export restrictions were eased in the context of supporting coproduction programs with the United States, Japan will still be required to focus on a limited range of technology priorities in funding future R&D and domestic weapons production.

Warming Relations with India

The Commission heard testimony that in recent years India and China have been moving closer in a shift that could affect the strategic realities of Asia. Economic ties are growing. Trade between India and China grew from a mere \$264.8 million in 1991 to \$4.3 billion in 2002.²⁸ Trade estimates for 2004–05 are closer to \$7 billion, and trade is projected to reach \$10 billion by 2005–06. China continues to draw in FDI at an order of magnitude higher than India (\$52.7 billion vs. \$5.5 billion in 2002). China is studying India's success in software development, while the popular surge for economic reform in India is hugely affected by China's example.

In April 2003, for only the second time in history, an Indian minister of defense paid an official visit to China. In 1998, at the time of India's test of a nuclear device, India's Defense Minister George Fernandes called China India's "potential threat number one," a greater threat than Pakistan. Fernandes' visit to China in 2003 was symbolic of how far Sino-Indian relations had come, although he carried with him a long agenda of concerns to raise with Chinese leaders, including China's ballistic missile assistance with Pakistan, military assistance to the Myanmar regime, and problems along the disputed Sino-Indian border.²⁹

Following the Fernandes visit, the first bilateral military exercise between China and India took place in November 2003, a joint naval search-and-rescue exercise off the coast of Shanghai. Such confidence-building measures are expected to continue, but the Indian national security leadership's fundamental perception that China poses a long-term strategic threat is unlikely to change.

China has in recent years emphasized its intent to pursue a balanced foreign policy toward India and Pakistan, a change from the past policy that was markedly in Pakistan's favor. This shift is likely a result of India's growing significance as an economic and

military power in Asia. Other issues, however, are increasingly affecting China's relations with Pakistan. Revelations of Pakistan's transfer of nuclear technology to North Korea have placed China in a difficult position vis-à-vis the international community and North Korea.³⁰

Outreach to Central Asia and Russia

China has continued to build its relations with the republics of Central Asia over the past two years, both bilaterally and through the Shanghai Cooperation Organization (SCO).³¹

Over the past two years, trade between China and the Central Asian republics and Russia has continued to grow steadily, from a relatively low base, and energy and transport projects linking China with Kazakhstan, in particular, continue to be developed. The SCO is becoming more active as a forum for regional economic relations. SCO members signed a framework agreement for economic cooperation in September 2003. In January 2004, the SCO established a formal secretariat in Beijing, headed by a former PRC vice minister of foreign affairs.

China's focus on security cooperation in Central Asia serves its goals of stabilizing its frontiers, countering international and domestic terrorism, and increasing political leverage in an area of the world that hosts a significant U.S. military presence. Even as the Central Asian republics and Russia are concerned about growing Chinese economic influence in their sparsely populated regions, they also hope transborder trade will stimulate local economies.

In the wake of the September 11 terrorist attacks, and as Operation Enduring Freedom was unfolding, the Chinese People's Liberation Army held its first peacetime military exercise with a foreign nation in October 2002, with the Republic of Kyrgyzstan, for the purpose of training border forces to deal with a possible terrorist-backed insurgency. Within the framework of the SCO, counterterror military forces from China and four other SCO members (Kazakhstan, Kyrgyzstan, Russia, and Tajikistan) engaged in a larger, two-phase exercise that took place in eastern Kazakhstan and western Xinjiang in mid-August 2003.³²

Hong Kong and China: Economic Partnership and Political Friction

As the 2004 Hong Kong Policy Act report notes: "U.S. interests in Hong Kong remain substantial. U.S. trade, investment, and business with Hong Kong, the world's 11th largest trading entity and 13th largest banking center, flourish in a largely open environment. In 2003, U.S. exports to Hong Kong totaled USD 13.5 billion, making Hong Kong our 14th largest overseas export market. U.S. direct investment in Hong Kong through 2002 amounted to over USD 35.8 billion. Over 1,000 resident American firms operate in Hong Kong, and Hong Kong is home to an estimated 50,000 American citizens."³³

In the past year, the Hong Kong Special Administrative Region (SAR) has experienced economic recovery tied to growth in its two largest markets, China and the United States, but its political relationship with China under the "one country, two systems" rubric has become tense. On July 1, 2003, five hundred thousand Hong

Kong people marched in protest of the SAR government's ill-advised introduction of a flawed security bill that was seen as going beyond what was required to implement the Hong Kong Basic Law's requirement, in article 23, to pass laws against such crimes as subversion, sedition, and secession. The SAR government withdrew its bill in the face of these protests and the loss of support from the probusiness Liberal Party members of the Legislative Council.

By the summer of 2003, Chinese leaders viewed these developments with growing concern. One response was to accelerate and finalize negotiations on China's first-ever FTA—the Closer Economic Partnership Arrangement (CEPA) with Hong Kong—as a means of showing China's concern for Hong Kong's economic welfare. CEPA, in effect since January 1, 2004, gives Hong Kong-origin goods and services special access to the Chinese market in advance of WTO liberalization timetables and, in some cases exceeding the benefits of China's WTO accession agreement. Billed as a WTO-consistent FTA, the CEPA does not discriminate on the basis of nationality; foreign, including U.S., firms duly established in Hong Kong are eligible to register as Hong Kong service providers. The CEPA has the potential, not yet realized, of making Hong Kong a more attractive place for certain types of manufacturing and for international service companies.³⁴

Despite the PRC's bestowal of CEPA, following the events of July, many Hong Kong people renewed calls for direct elections, seen as offering the best guarantee of a responsive government that would preserve individual rights and protections, such as those the draft security legislation had seemed bound to erode.

The Hong Kong Basic Law provides that the direct election by universal suffrage of the chief executive and all of the Legislative Council should be the ultimate aim. Direct election could be adopted as the method used to select the chief executive as early as 2007 and to form all of the legislature in 2008.³⁵ The Basic Law requires a two-thirds majority vote by the Legislative Council, approval by the chief executive, and approval of or notification to, in the case of Legislative Council rules the National People's Congress Standing Committee (NPCSC) for any change in the method of selecting the chief executive or forming the Legislative Council.³⁶ Hong Kong proponents of an early adoption of direct elections have called for direct consultations with the Special Administrative Government on this matter, but the chief executive, C.H. Tung, has declined to do so. Instead, he set up in January 2004 a Task Force on Constitutional Development that has collected views of the public and forwarded them to the NPCSC.

On April 6, 2004, the NPCSC, on its own initiative, issued an interpretation of the Basic Law asserting that only the NPCSC would decide, upon receiving a report from the Hong Kong chief executive, whether any change in electoral processes was needed. It further confirmed that the Legislative Council would not have the right to initiate bills in Hong Kong to establish in local law any new electoral procedures or methods of voting on legislation. Following receipt of a report from Chief Executive Tung recommending a change in electoral procedures, on April 26, 2004, the NPCSC

promptly issued a ruling that in 2007 and 2008, no changes would be made.

This string of decisions has been met with dismay by Hong Kong advocates of greater democracy.³⁷ Beijing set an ominous precedent by preemptively intruding on governance issues that could easily have been considered within the competency of the Hong Kong SAR. By ruling as it did, the NPCSC shut out the Legislative Council from the early stage of deciding whether changes in electoral rules are necessary as well as the later implementation phase should any change be approved in principle by the NPCSC. This move ensured total control of the process by Beijing. China's foreign ministry has brushed away critical comments on the NPCSC action, including statements by the U.K. and U.S. governments. China insists that the National People's Congress has the ultimate authority to interpret the Basic Law, a national law of the PRC, and that the matter is completely an internal one.

Emphasizing the point, Beijing's representative in Hong Kong declared in early May that "any move by Legislative Councilors in Hong Kong to advance motions to voice discontent or condemn the April 26 decision is against the law. ... [It] cannot be questioned or challenged."³⁸ This shutting off of debate coincided with a visit to Hong Kong by eight PLA Navy warships—the largest Chinese flotilla sent to Hong Kong since the 1997 handover. Combined with Beijing's campaign to discredit democratic activists as unpatriotic, these moves constitute a clear campaign of intimidation.

Questions are consequently being raised in Hong Kong and elsewhere about whether Beijing's actions have undermined the high degree of autonomy envisioned under the Sino-British Joint Declaration of 1984 and the Hong Kong Basic Law and the principle of "one country, two systems." As a matter of U.S. policy, the question could well arise whether the provisions of section 202 of the U.S. Hong Kong Policy Act should be invoked: "... whenever the President determines that Hong Kong is not sufficiently autonomous to justify treatment under a particular law of the United States, or any provision thereof, different from that accorded the People's Republic of China, the President may issue an Executive Order suspending the certification of section 201 (a) [regarding continued separate application of U.S. laws with respect to Hong Kong]."³⁹

It remains to be seen whether the PRC government will try to erode further Hong Kong's autonomy, such as by intervening in the question of article 23 (security) legislation, and to what degree the Hong Kong populace resists. Additional poorly judged moves by Beijing could have the effect of damaging Hong Kong's business environment, and U.S. long-term interest in an open and prosperous Hong Kong could well suffer. The bond rating agency Moody's, in a May 2004 report, cited doubts over whether Beijing will support democracy in Hong Kong even in future years as a reason the agency might downgrade Hong Kong's credit rating to be on a par with China's lower rating.⁴⁰ Aside from direct economic and trade interests in Hong Kong, the United States has an inherent interest in the protection of individual rights and the development of democracy in Hong Kong and also seeks Hong Kong's support in the global fight against terrorism, maintains a cooperative inter-

national law enforcement relationship, and continues to obtain access to Hong Kong as a port of call for U.S. ships and aircraft.

Cross-Strait Relations: Economic Ties Grow, Political Tensions Rise

Since China and Taiwan's respective entries into the WTO, cross-Strait economic integration has accelerated despite the lack of direct transport links. An estimated sixty thousand Taiwan-owned firms operate on the mainland, with a total stock of FDI estimated between \$70 billion and \$100 billion. In 2003, China was the destination for more than half of the island's total overseas investment, \$7.7 billion. Meanwhile, Taiwan's total inward FDI declined to \$3.58 billion in 2003 from \$7.61 billion in 2000. Nearly seven thousand factories were shut down in Taiwan in 2003, more than double the 2002 figure.⁴¹

Although exact numbers are difficult to calculate due to the role of intermediate channels, Taiwan has probably provided the greatest single stream of FDI into China during the past decade. The progressive migration of industries (including most segments of its vital information technology industry) out of Taiwan to coastal China is seen as contributing to historically high unemployment in Taiwan which reached 5.2 percent in August 2003, though dropping to 4.3 percent in April, 2004. Even as investment flows from Taiwan to the mainland continued at high levels, gross domestic investment on Taiwan hit a four-year low of \$48.2 billion in 2002.⁴² It recovered slightly in 2003, to about \$48.6 billion. These numbers contribute to a widespread impression that Taiwan business is not reinvesting on the island, preferring mainland alternatives.

Taiwan and PRC government statistics on cross-Strait trade differ. Transshipments of goods via Hong Kong, underreporting in Taiwan, and overreporting in the mainland are probably the reasons for this. Nonetheless, sides' numbers show China has become Taiwan's top trading partner in 2003. The PRC claims two-way trade reached more than \$58 billion in 2003,⁴³ whereas the Taiwan Board of Foreign Trade announced March 1 that total cross-Strait trade was \$46.3 billion, with Taiwan enjoying a \$24.4 billion surplus on exports of \$35.4 billion.⁴⁴ China has become Taiwan's largest export market, surpassing the United States in 2002 and 2003.

Taiwan's exports to the mainland increased by twenty percent in 2003. They accounted for 34.51 percent of Taiwan's total exports, up from 23.97 percent in 2000, according to Taiwan's economic ministry. Professor Peter Chow of the City University of New York refers to this state of affairs as Taiwan's asymmetric trade dependence on China's market, as China's exports to Taiwan in recent years have amounted to only about two to three percent of the PRC's total exports.⁴⁵

In the information technology sector, Taiwan semiconductor and electronics manufacturing firms are major global actors, and their expansion into China continues, but without noticeable erosion of Taiwan equity control. In testimony before the Commission, Merritt Cooke, former senior commercial officer at the American Institute in Taiwan, attributed this to the relative stability of "highly differentiated, high-value supply chains" as opposed to the "instability of far simpler manufacturer-retailer networks characteristic

of commodity products.” Cooke believes this distinction helps explain the historical pattern of Taiwan investment into the mainland. While many light industry sectors that Taiwan moved to the mainland in the 1980s and 1990s “have been swallowed up by mainland competitors,” highly differentiated, relatively high-value consumer products such as brand-name athletic shoes and high-performance bicycles have remained largely in Taiwan equity hands. “If these product sectors, with their relatively lower levels of technology and slower product cycles, could stay in Taiwan control for decades, there is every reason to believe that the various IT [information technology] hardware sectors will stay even more firmly in Taiwan’s grip in years ahead,” Cooke said.⁴⁶

Despite the large and growing Taiwan business presence in the mainland and burgeoning indirect cross-Strait trade and investment, there is a sense in the Taipei business community that Taiwan itself—as a venue for investment, manufacturing, logistics, or finance—is in danger of becoming marginalized within Asia. Kaohsiung’s container port—once the fourth busiest in the world—now ranks sixth, with the Chinese ports of Shenzhen and Shanghai jumping ahead. The American Chamber of Commerce in Taiwan reports that a number of U.S. corporations’ regional headquarters in Taiwan have been eliminated or downgraded to local offices.⁴⁷

PRC’s Campaign to Isolate Taiwan

The growing sense of marginalization is intensified by the PRC’s determination to exclude Taiwan from multilateral forums and the work of international organizations. Beijing’s initial move to block visits by World Health Organization officials to Taiwan in the spring of 2003, during the height of the SARS (severe acute respiratory syndrome) crisis, was an extreme example of this, but repeated in large and small ways around the world. China has fought over Taiwan government nomenclature submitted in WTO technical documents.⁴⁸ Beijing is widely believed to have used its political and economic leverage to dissuade other countries in the region from entering into FTA negotiations with Taiwan. Taiwan’s first and so far only FTA was signed in August 2003 with Panama, one of the twenty-six countries that extend diplomatic recognition to Taiwan; Panama ranks seventieth among Taiwan’s trading partners. Taiwan traders and business people are concerned that China is using its ASEAN FTA and Hong Kong CEPA initiatives to encroach further on Taiwan’s economic and commercial space.⁴⁹

In talks with Taiwan and U.S. business executives in March, Commissioners heard suggestions that the United States should consider reviving the process of negotiations on a U.S.-Taiwan Free Trade Agreement (FTA), if only to signal to others in the region that the United States is interested in helping Taiwan break out of its growing economic isolation. The United States has suspended bilateral trade negotiations pending substantial progress by Taiwan on a number of existing trade barriers to U.S. producers—including in the area of intellectual property protection, pharmaceuticals, telecommunications services, and agricultural products. Taiwan reportedly is making some progress in meeting U.S. concerns in some of these areas.

The other major factor behind the sense of marginalization is the loss of momentum to establish direct trade, transport, and communications links (the “Three Links”) across the Taiwan Strait. As China becomes more central to Asia’s regional economy and global supply chains, the lack of direct links across the Strait constrains Taiwan from taking advantage of its geographical proximity to the fastest-growing large economy in the world. In years past, Taiwan management skills and technology were highly prized by developing mainland coastal regions, and China took the initiative to foster the idea of early agreement on the Three Links. It is not evident that China has the same incentives to promote direct links, even as it senses a heightened interest in them within the Taiwan business community.

For more than six years, there has been little public dialogue on the Three Links, or on any other matter, between the two sides of the Strait. Taiwan President Chen Shui-bian’s unilateral initiative to establish the “mini-Three Links” between Taiwan’s small offshore islands of Kinmen and Matsu and neighboring mainland ports has not led to more than local exchanges of visitors and goods. During Chen’s first term, China initially refrained from moving any distance toward Chen’s position on dialogue. Beijing insisted that any talks even on technical subjects like maritime trade, could be conducted only after Chen’s government accepted the PRC’s “one China principle” that there is only one China in the world and that Taiwan is a part of China. Chen refused to accept preconditions, and the one China principle goes against his own policy statements that, while the possibility of a future one China exists in theory, one China does not exist now, and that Taiwan, as the Republic of China, is an independent sovereign state separate from the PRC.

China has more recently suggested it would be willing to sponsor unofficial talks on technical issues, but Chen, citing legal strictures against nonofficials negotiating on behalf of the government, has been unwilling to countenance a Taiwan delegation that was not led by responsible officials of his government.

Taiwan Election: Identity Politics Wins, Cross-Strait Tension Rises

The dramatic March 20, 2004, presidential election in Taiwan—with the election eve shooting of Taiwan President Chen and Vice President Lu, the extremely narrow margin of Chen Shui-bian’s election victory, and the postelection lawsuits and contentions raised by the opposition “Pan-Blue” KMT–PFP alliance—has frozen the cross-Strait situation for now. It is clear from public statements of President Chen and his advisors that he would like to make improvement of cross-Strait relations a high priority for his second and last term in office, with a focus on establishing a framework of peace and stability that would lead to negotiations on both political relations and practical matters such as the Three Links.⁵⁰ Yet such statements are negated, in the mind of Beijing leaders, by Chen’s expression of pride that his narrow victory is a vindication of identity politics in Taiwan and is a mandate for solidifying Taiwan’s separate status.

Following the election, President Chen's repeated public references to Taiwan as an independent, sovereign country and his promise to initiate constitutional reforms or amendments in the 2006–08 time frame give no comfort to leaders in Beijing, who suspect that Chen is determined to formalize Taiwan's independence. A senior PRC Taiwan Affairs Office spokesman publicly condemned Chen as stubbornly insisting on a Taiwan independence separatist stance and further claimed Chen's "actions have ruined Taiwan society, damaged cross-strait relations, and posed a direct threat to peace and stability in the Asia-Pacific region."⁵¹

Chen and his government will be walking a tightrope as they seek to solidify the Taiwan people's freedoms and democracy, maintain adequate defenses against PRC coercion, and revive cross-strait dialogue while preserving good relations with Taiwan's strongest supporter, the United States. Chen's May 20, 2004, inaugural address will be a guide to his second-term, cross-strait policies and will be read meticulously by all concerned in Beijing and Washington.

Changing Cross-Strait Realities; U.S. Policy

The cross-strait situation of the past six months has been characterized by crisis management. Beijing issued official denunciations of Taiwan's passage of a referendum law in November 2003 and of Taiwan President Chen Shui-bian's plan to put forward referendum questions to be voted on during the March 20, 2004, presidential election. PLA military exercises on the China coast opposite Taiwan and the April 2004, arrest of Major General Liu Guangzhi, the former head of the PLA Air Force Command College, for spying for Taiwan added to a potentially dangerous string of events that cumulatively could have sparked military conflict.

The response of the United States to these events shows how convoluted U.S. cross-strait policy has become since the framework was established twenty-five years ago. This was evident during President Bush's meeting in Washington with PRC Premier Wen Jiabao on December 9, 2003, at a time when it was perceived that Chen Shui-bian was considering posing referendum questions that would relate to Taiwan independence or unification with the mainland. Speaking to the press, President Bush said, "The United States Government's policy is one China, based upon the three communiqués and the Taiwan Relations Act. We oppose any unilateral decision by either China or Taiwan to change the status quo." The president reportedly reaffirmed in private to Premier Wen his administration's firm opposition to the use of force against Taiwan, but he told the press that "the comments and actions made by the leader of Taiwan indicate that he may be willing to change the status quo, which we oppose."⁵²

The referendum questions that finally were posed to Taiwan voters in March 2004—on the need for spending on missile defenses and for initiating government to government talks with the PRC—did not touch on the question of Taiwan's status. In any event, they did not obtain the necessary majority of registered voter participation in order to pass. Nonetheless, President Chen's proposal for constitutional revision—most likely through a referendum to take place in 2006—is likely to be met by additional PRC pressure to

pull Taiwan back from steps that Beijing believes could lead to Taiwan's permanent separation. Chen has insisted his constitutional proposals—not yet fully formed—will be designed to improve the functioning of Taiwan's government and not to change the status quo.⁵³

The United States has a continuing interest in peace and security in the Taiwan Strait and encourages cross-Strait dialogue. Since President Bush's December 9, 2003, remarks, senior U.S. officials have continued to urge both sides not to take unilateral measures to change the status quo as defined by the United States. For example, in recent testimony before the House International Relations Committee, Assistant Secretary of State James Kelly made clear that "[T]he U.S. does not support independence for Taiwan or unilateral moves that would change the status quo as we define it."⁵⁴

The United States' one China policy—which is based principally on the three Sino-U.S. communiqués and the Taiwan Relations Act—is challenged by recent developments across the Taiwan Strait. Taiwan's evolution into a viable, constitutionally based democracy, with the full panoply of democratic practices and institutions, including heavy participation in elections, is in stark contrast to the continuation of an authoritarian, one-party state on the mainland. Beijing continues to assert that Taiwan must be united with the mainland, and although it professes it prefers unification be obtained peacefully, Beijing has never ruled out the use of force to compel Taiwan. The PRC poses an increasing military threat to Taiwan through its missile deployments and military modernization program, which are clearly shaped both to apply coercive force and to fit a future Taiwan conflict scenario. See Chapter 8 for detailed findings on China's military modernization and the cross-Strait military balance.

In view of U.S. commitments under the 1979 Taiwan Relations Act (TRA) to provide Taiwan with the wherewithal to defend itself and to view with grave concern any attempt to resolve the Taiwan issue by coercion or military force, the United States cannot presume that the currently frozen cross-Strait situation serves long-term U.S. national interests. China's growing military power and its increased economic and political clout in the region have altered the cross-Strait strategic balance. Taiwan's politics have also changed the picture, as the results of the presidential election have, in the mind of the Democratic Progressive Party leadership, vindicated Chen Shui-bian's emphasis on Taiwan sovereignty and separate identity. The fact remains that the PRC does not exercise any operational, political, or economic jurisdiction or sovereignty over Taiwan. On the other hand, the United States does not recognize any de jure independent political sovereignty on the part of Taiwan but is committed under the TRA to resist any attempt by the PRC to incorporate Taiwan into its political orbit by force or to compel a change to its economic and social systems.⁵⁵

The United States should consider new approaches to help China accept the realities of the present situation and work to loosen the strictures China has placed on Taiwan internationally while facilitating some form of cross-Strait dialogue that could lead to direct links between Taiwan and the mainland. The hope would be that

once such a dialogue was established, particularly in view of the extensive economic ties between the two sides, it could lead to broader confidence-building measures.

RECOMMENDATIONS

Regional Engagement

- The Commission recommends that Congress revitalize U.S. engagement with China's Asian neighbors by encouraging U.S. diplomatic efforts to identify and pursue initiatives to demonstrate the United States' firm commitment to facilitating the economic and security needs of the region. These initiatives should have a regional focus and complement bilateral efforts. The Asia-Pacific Economic Cooperation forum (APEC) offers a ready mechanism for pursuit of such initiatives. The United States should consider further avenues of cooperation by associating with regional forums of which it is not a member.

Hong Kong

- The Commission recommends that Congress consult with the administration to assess jointly whether the PRC's recent interventions impacting Hong Kong's autonomy constitute grounds for invoking the terms of the U.S.-Hong Kong Policy Act with regard to Hong Kong's separate treatment. This includes U.S. bilateral relations with Hong Kong in areas such as air services, customs treatment, immigration quotas, visa issuance, and export controls. In this context, Congress should assess the implications of the National People's Congress Standing Committee's intrusive interventions with regard to matters of universal suffrage and direct elections. Congress and the administration should continue to keep Hong Kong issues on the U.S.-PRC bilateral agenda and work closely with the United Kingdom on Hong Kong issues.

Cross-Strait Issues

- The Commission recommends that Congress enhance its oversight role in the implementation of the Taiwan Relations Act. Executive branch officials should be invited to consult on intentions and report on actions taken to implement the TRA through the regular committee hearing process of the Congress, thereby allowing for appropriate public debate on these important matters. This should include, at a minimum, an annual report on Taiwan's request for any military equipment and technology and a review of U.S.-Taiwan policy in light of the growing importance of this issue in U.S.-China relations.
- The Commission recommends that the Congress and the administration conduct a fresh assessment of the one China policy, given the changing realities in China and Taiwan. This should include a review of:
 - The policy's successes, failures, and continued viability;
 - Whether changes may be needed in the way the U.S. government coordinates its defense assistance to Taiwan, including the need for an enhanced operating relationship between U.S. and Taiwan defense officials and the establishment of a U.S.-Taiwan hotline for dealing with crisis situations;

- How U.S. policy can better support Taiwan's breaking out of the international economic isolation that the PRC seeks to impose on it and whether this issue should be higher on the agenda in U.S.-China relations. Economic and trade policy measures that could help ameliorate Taiwan's marginalization in the Asian regional economy should also be reviewed. These should include enhanced U.S.-Taiwan bilateral trade arrangements that would include protections for labor rights, the environment, and other important U.S. interests.
- To support this policy review, the Commission recommends that the appropriate committees of Congress request that the executive branch make available to them a comprehensive catalogue and copies of all the principal formal understandings and other communications between the United States and both China and Taiwan as well as other key historical documents clarifying U.S. policy toward Taiwan.
- The Commission recommends that Congress consult with the administration on developing appropriate ways for the United States to facilitate actively cross-Strait dialogue that could promote the long-term, peaceful resolution of differences between the two sides and could lead to direct trade and transport links and/or other cross-Strait confidence-building measures. The administration should be directed to report to Congress on the status of cross-Strait dialogue, the current obstacles to such dialogue, and, if appropriate, efforts that the United States could undertake to promote such a dialogue.

ENDNOTES

1. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impacts and Implications*, testimony of Bates Gill, December 4, 2003, p. 5.
2. China's joining the Asian "Shift Toward Regionalism" is outlined in the written testimony of Richard Feinberg and Stephen Haggard for the U.S.-China Economic and Security Review Commission, *Hearing on China as an Emerging Regional and Technology Power: Implications for U.S. Economic and Security Interests*, February 12–13, 2004, pp. 64–70.
3. Michael Vatikiotis and Murray Heibert, "How China is Building an Empire," *Far Eastern Economic Review* (November 20, 2003). See also Phillip P. Pan, "China's Improving Image Challenges U.S. in Asia," *Washington Post*, November 15, 2003.
4. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impacts and Implications*, testimony of John J. Tkacik, December 4, 2003, p. 15.
5. Top Asian sources of FDI to China, 2001: Hong Kong, 36.0 percent; Japan, 9.8 percent; Taiwan, 6.7 percent; Singapore, 4.6 percent; South Korea, 4.2 percent. A significant portion of Hong Kong investment and most of the 10.8 percent of FDI listed as sourced from the Virgin Islands is probably attributable to Taiwan. Source: Ministry of Foreign Trade and Economic Cooperation and U.S.-China Business Council, as cited in Allen Lenz, "World Trade and Investment: An Overview" (report prepared for the U.S.-China Economic and Security Review Commission [Washington, DC: October 2003]).
6. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impacts and Implications*, testimony of Wing Thyee Woo, December 4, 2003, p. 25.
7. U.S.-China Security Review Commission, *Report to Congress: The National Security Implications of the Economic Relationship between the United States and China* (Washington, DC: July 2002), p. 37.
8. *Country Fact Sheet: China*, (Geneva, Switzerland: UN Conference on Trade and Development.) Available at www.unctad.org/wir.

9. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the U.S.*, testimonies of Peter Nolan and Edward Steinfeld, September 25, 2003, pp. 98–144.

10. See figure 4.1, *Leading Exporters and Importers in World Merchandise Trade, 2002 & 2003*, World Trade Organization. Available at www.wto.org/english/news_e/pr373_e.htm.

11. "China Doubles its Trade Deficit with South Korea," *Asia Pulse/Yonhap*, April 2, 2004.

12. "China-ASEAN Trade Records New High," *Xinhuanet*, February 8, 2004. Available at news.xinhuanet.com/english/2004-02/08.

13. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Edward Lincoln, December 4, 2003, pp. 82–88.

14. Commission discussions with Japanese business representatives in Tokyo, March 2004.

15. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Gordon Flake, December 4, 2003, p. 98.

16. The preceding paragraph draws heavily on Scott Snyder, "No Shows, Economic Growth, and People Problems," *Comparative Connections*, ejournal of CSIS Pacific Forum, 4th quarter, 2003. Available at www.csis.org/pacfor/cc/0304Qchina_skorea.html.

17. See, for example, U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Wing Thye Woo and Naoko Munakata, December 4, 2003, pp. 16–35 and pp. 104–127.

18. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Wing Thye Woo, December 4, 2003, pp. 23–24; see also Yongzheng Yang, "China's Integration into the World Economy: Implications for Developing Countries," *International Monetary Fund Working Paper*, WP/03/245 (Washington, DC: IMF, December 2003).

19. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Naoko Munakata, December 4, 2003.

20. Bruce Klingner, "'Peaceful Rising' Seeks to Allay 'China Threat,'" *Asia Times Online*, March 12, 2004.

21. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Bates Gill, December 4, 2003, pp. 5–6.

22. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Naoko Munakata, December 4, 2003, p. 112.

23. Blas F. Ople, "Horizons," *The Manila Bulletin*, November 6, 2002.

24. Phillip P. Pan, "China's Improving Image Challenges U.S. in Asia," *Washington Post*, November 15, 2003.

25. *Ibid.*

26. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Wang Gungwu, December 4, 2003.

27. Observations in this section are based primarily on Commissioners' conversations with government officials, business representatives, and journalists in Tokyo, March 14–16, 2004.

28. "Conflict With China Not Inevitable, says India," *Agence France Presse*, January 28, 2003.

29. "Fernandes Leaves for China," *Hindu*, Chennai, India, April 20, 2003; see also Ramananda Sengupta, "China-India: A Cautious Handshake," rediff.com, April 21, 2003.

30. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, written testimony of Rollie Lal, December 4, 2003, p. 170.

31. The Shanghai Cooperation Organization, officially established in June 2001, comprises China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan.

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33. *U.S.-Hong Kong Policy Act Report* (Washington, DC: U.S. Department of State, April 1, 2004).

34. Commission discussions with Hong Kong economic and trade officials, March 15, 2004.
35. In 2004, one-half of the Legislative Council (thirty out of sixty seats) will be elected directly by geographic constituencies; the other half indirectly, by professional, business, labor, and other "functional constituencies."
36. See annex I, section 7, and annex II, section III, *The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China* (Hong Kong: Government Printer, January 1996).
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38. "Threatening Hong Kong," *Washington Times*, May 11, 2004.
39. See 22 U.S.C. 66, U.S.-Hong Kong Policy Act of 1992.
40. "Throttling the Golden Goose," *Asian Wall Street Journal*, May 10, 2004.
41. "Taiwan's Workers Groan and Businesses Gripe," *Agence France Presse*, March 15, 2004. Available at etaiwannews.com/business/2004/03/15/1079316687.htm.
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49. U.S.-China Economic and Security Review Commission, *Hearing on China's Growth as a Regional Economic Power: Impact and Implications for the U.S.*, testimony of Merritt Cooke, December 4, 2003, p. 48.
50. See, for example, Philip Pan and David E. Hoffman, interview with President Chen Shui-bian, *Washington Post*, March 29, 2004.
51. "Text of PRC's Taiwan Affairs Office News Conference on Taiwan Election," *Beijing CCTV-4* (in Mandarin), Foreign Broadcast Information Service, translated English text, ref. no. CPP20040414000027 Beijing CCTV-4 in Mandarin, April 14, 2004.
52. Quoted and further analyzed in Ralph Cossa, "Does Taiwan's Leader Know When to Stop?" *International Herald Tribune*, December 17, 2003.
53. "Chen Vows Constitutional Reform," *BBC News UK Edition*, found at <http://news.bbc.co.uk/1/hi/world/asia-pacific/3581407.stm>, March 30, 2004. In a March 22, 2003, interview with the BBC, quoted in this article, Chen said: "We want to put the new constitution to a direct referendum of the people to decide whether they want to accept the new constitution or not, and this new constitution will have no bearing on the issue of unification or independence, nor will it change the status quo."
54. See statement of James Kelly, assistant secretary of State, before the House International Relations Committee, April 21, 2004.
55. See especially section 2(b)(6) and section 3(c), Taiwan Relations Act of 1979, 22 U.S.C. 3301. Section 2(b)(6): "It is the policy of the United States—to maintain the capacity of the United States to resist any resort to force or other forms of coercion that would jeopardize the security, or the social or economic system, of the people on Taiwan." Section 3(c): "The President is directed to inform the Congress promptly of any threat to the security or the social or economic system of the people on Taiwan and the danger to the interests of the United States arising therefrom. ..."